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Union Committee

RD-668

February 7, 1994

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The Honorable Dan Morales
Attorney General of Texas
7th Floor, Price Daniels Sr. Bldg.
Austin, Texas 78701

RE: Request For Opinion

Dear General Morales:

The Employees Retirement System of Texas (ERS) administers the retirement program for employees of the State of Texas. Among the tasks assigned to the ERS is the investment of retirement system assets in order to ensure the growth and adequacy of the funds necessary to pay annuities to our retirees.

The ERS investigates and evaluates available investment vehicles for suitability to the investment program and is currently evaluating a type of investment vehicle known as equity swap contracts and, more specifically, interest rate swap contracts. These investments have been offered for more than a decade and may be used as a conservative means of participation in domestic and international stock markets. Other uses include the exchange of a fixed rate of income for a variable rate, or vice versa, which an investor may wish to use as a protective measure during rising or falling interest rate environments. Several public retirement funds in other states have approved swap contracts for investment of their funds, but no public retirement system in Texas has to our knowledge done so.

The mechanics of a swap contract are approximately as follows. An investor, such as the ERS, negotiates a contract with a broker or dealer whereby agreed upon cash flows are exchanged. For example, the investor, the ERS, wanting to gain exposure to a particular foreign stock index, might contract to exchange the cash flow of some fixed income or money market security already owned or to be purchased by the ERS in return for a percentage of the appreciation in the value of the agreed upon stock index. Alternatively, the ERS could exchange a cash flow equivalent to some published interest rate as a percentage of some agreed upon amount, known as the notional amount. The cash flow is paid by the investor periodically throughout the term of the contract, while the percentage of the stock market appreciation value due to the investor is paid at the end of the term of the contract. The advantage to the investor is an opportunity for equity exposure with the potential of returns greater than from the underlying fixed income security. While the principal remains safe, the anticipated income stream is invested in a manner that provides for diversity of the investments. If the stock index declines, all that has been risked is the income stream from the fixed income security; and the principal amount of the original investment is still received at maturity.

The basic authorization for the investment of ERS funds is Texas Constitution Article XVI, Section 67, Subsection (a)(3), which authorizes the ERS Board of Trustees (the Board) to administer the system and to invest its funds:

. . . in such securities as the Board may consider prudent investments. In making investments, the Board shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income therefrom as well as the probable safety of their capital, the legislature by law may further restrict the investment discretion of a Board.

The term "securities" is not defined in the Texas Constitution.

The Texas Legislature has enacted certain laws regarding the investment authority of the ERS. Texas Government Code, Section 815.103(b) provides that the Board may acquire, hold, manage, purchase, sell, assign, trade, transfer, and dispose of any security, evidence of debt, or other investment in which the retirement system's assets may be invested. Section 815.103(c) permits investment in certain other assets described in Texas Government Code, Section 815.305.

Texas Government Code also addresses in Sections 815.301, *et. seq.*, the ERS' management of assets. Section 815.301(b) provides that the Board may invest and reinvest any of the system's assets under the standard of care provided by Section 815.307. Texas Government Code, Section 815.307 tracks the Constitutional language in addressing the duty of care to be used in making investments:

In making investments for the retirement system, the board of trustees or the executive director shall exercise the judgment and care, under the circumstances prevailing at the time of the investment, that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in speculation but when making a permanent disposition of their funds, considering the probable income from the disposition and the probable safety of their capital.

Although a number of provisions in the law address the investment authority of the ERS, none specifically defines the term "securities" and what investment vehicles the term may include. The Texas Securities Act, referred to as the "Blue Sky" law (Vernons R.C.S. art. 581 *et. seq.*) defines the term "security" or "securities" at art. 581-4A. In Attorney General No. MW-152, regarding investments by the Teacher Retirement System of Texas (TRS), the Attorney General looked to the definition of "securities" used in the Blue Sky law. The term "security" is also defined in the Federal Securities Act of 1933 (15 U.S.C. Sec. 77A *et. seq.*) and the Securities and Exchange Act of 1934 (15 U.S.C. Sec. 78a *et seq.*). Both the Texas Blue Sky law and the federal securities laws define "security" to include a variety of investment vehicles from basic stocks and bonds, to oil and gas leases, to such broad categories as "investment contracts". Both the state and federal securities laws define the term "security" broadly in such a way as to expand the scope of regulatory authority.

It is evident that, at the time the applicable Constitutional and statutory provisions were drafted, investment in "securities" was intended to include investment in basic stocks and bonds. However, it is not altogether clear whether the term "securities" must necessarily be interpreted either to include or exclude the derivative investments described above, which have only been developed in recent years, in the scope of authorized investments for the ERS.

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Your opinion is, therefore, requested in response to the following question:

Are swap contracts a permissible form of investment for the funds of the Employees Retirement System of Texas under the investment authority of the Texas Constitution and statutes?

Sincerely,


CHARLES D. TRAVIS
Executive Director

CDT/EVN/sh